

The Corporation Trust Company Journal

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SUPPLEMENT

Comments on the Federal Corporation Tax Law.

Issued in

New York, Boston, Philadelphia, Chicago and St. Louis

✓ **AN IMPORTANT DECISION ON PROMOTERS LIABILITY** was handed down by the Supreme Court of Massachusetts in the case of the Old Dominion Copper Mining & Smelting Company vs. Bigelow, on September 14th of this year. The Court affirmed judgment against one of the promoters of the company for about \$2,000,000, secret profits obtained at the time of its organization. The prevailing opinion was by Mr. Justice Rugg. It is of great length and is an exhaustive discussion of the legal principles involved. Three judges, including the Chief Justice, dissented. As established by this decision, the law in Massachusetts now is that a corporation may at any subsequent time, whenever free from the control of the original promoters, sue and recover undisclosed profits of the promoters, notwithstanding that the management may have year after year received a majority of proxies and ratified at annual meetings all its acts and records. On October 21st an application for rehearing was denied by the Court.

✓ **A DECISION IN THE SUPREME COURT OF MICHIGAN** (Torrey vs. Toledo Portland Cement Company, October, 1909, 122 N. W., 614) holds that promoters of a corporation sustain a fiduciary relation towards other stockholders and creditors, and if those with whom they dealt in this fiduciary capacity suffered loss by the concealment of fact or misrepresentation the promoters are liable.

✓ **THE LIABILITY OF DIRECTORS TO CREDITORS** in New York, referred to in the November, 1908, number of this Journal (Darcy vs. Brooklyn & New York Ferry Company, 127 App. Div., 167), was confirmed by the New York Court of Appeals, October 19, 1909. In this case the entire assets of the corporation were transferred to another corporation and the consideration was paid over to the vendor's stockholders without formal dissolution proceedings. The directors were held personally liable for a judgment against the vendor founded upon a claim which was unknown to the directors at the time of transfer. In affirming the judgment the Court holds that *some* notice should have been given to all creditors, and failing to do so the directors are liable notwithstanding that they acted in good faith and without fraud in making the transfer and the purchasing corporation agreed to assume all of the existing debts of the selling company.

IN CUBA, by a decree of President Gomez, dated October 25, 1909, all corporations—domestic and foreign—will be required to file with the Secretary of Agriculture, Commerce and Labor a copy of their charter and all other data necessary to present a complete record. These corporations will be required to faithfully fulfill all the provisions of their charter and by-laws and to conform with the laws of Cuba. Their statements and books will be open to official inspection, and the Secretary of Agriculture is given authority to proceed against any corporations because of irregularities. The decree is considered by many to be unconstitutional and it may be tested in the courts.

SUPPLEMENT

TO

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Journal**

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The Federal Corporation Tax Law

A summary of editorial and other comments on its supervisory, regulative and revenue features and a statement of the action taken by various business associations with regard to the law.

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Few measures of legislation have received so much comment, criticism, ridicule and denunciation as the Federal Corporation Tax Law which was sprung upon the country so suddenly last summer. It has received attention from all experts on taxation and has been commented upon in the editorial columns of nearly every newspaper in the country. The few remarks in its favor have been drowned by the storm of hostile comment, which even Republican newspapers have showered upon it. It has been called a partial income tax masquerading under the name of excise tax. It has been asserted that its real purpose was a step towards the federal supervision and control of all corporations and that its revenue feature was a negligible quantity.

While manufacturing and commercial interests were given the fullest opportunity for criticism and objection to the tariff measures, the bankers and insurance people seem to be the only interests whose objections to the proposed corporation tax law, as it was first drafted, resulted in any modification of the measure before it was placed on the statute books. The public accountants seem to have a special grievance in that their suggestions were not heeded, although a group of New York professional accountants called the attention of the Attorney-General to what they considered the ill-fitting adjustment of the requirements of the law while it was yet before Congress.

The law went into effect on August 5, 1909, the day after it was signed by the President, but its provisions require that the first return be made for a period covering the calendar year commencing the first day of January previous to its enactment. This did not seem to dawn upon the newspapers until October 6th when editorials appeared in the New York dailies calling attention to the fact that the law reached back seven months prior to its passage and was one of the very few revenue measures ever enacted by congress of a retro-active character. This feature of the law, however, was soon forgotten in the storm of protest against its other features.

The law has been referred to as a compromise measure. The Cincinnati *Inquirer* retorts by saying it is meeting the fate of all compromise measures in that it suits no one. The New York *Commercial* speaks of it as a revolutionary tax.

The *Journal of Commerce* says it is a demoralizing method of taxation. The *Wall Street Journal* chimes in by adding that it ignores fiscal experience. The New York *Financial Chronicle* thinks that the small concern will be the victim. The Boston *Transcript* characterizes it as taxation for "ulterior purposes." The *Ohio State Journal* speaks of the trend towards centralization evidenced by the passing of the law. The Portland (Oregon) *Journal* says "the corporation tax is utterly illogical—corporation capacity is a thing that can be put on or off at will," and it believes that many corporations may dissolve in order to avoid the tax. The Portland *Oregonian* believes the tax most inequitable and prophesies that it will plague the administration and Republican party hereafter.

The New York *Times* comments as follows:

"This tax is offensive because of what it omits as well as what it includes. The state taxation is erratic, but the federal tax is levied without any corresponding compensation."

The New York *World* denounces the law because

"It gives to the President of the United States an autocratic and irresponsible power that should never be lodged in the hands of any man under free institutions. . . . There can be no excuse for a vicious un-American precedent in government on the ground that no serious damage is likely to result during the next four years."

President De Boer of the National Life Insurance Company of Vermont denounces the law because it has a tendency to overburden certain classes of corporations, notably those which have to do with life insurance and banking, which he thinks are already overburdened. The bankers, however, are congratulating themselves on the timely and wise action of the Federal Legislative Committee of the American Bankers Association in calling the attention of members of congress to the inequalities which would have been suffered by banks under the law as it was first drafted in not being allowed to deduct the full amount of interest on deposits paid out from gross earnings in order to arrive at net earnings.

The insurance companies also obtained certain concessions in the law after several conferences with the Attorney-General prior to its passage.

Allen Ripley Foote, President of the International Tax Association, characterizes the corporation tax law as "a crime against American business men." In an address before the American Association of Public Accountants at Denver, he is reported as saying:

"The enactment of the Federal Law taxing corporate incomes was a mistake. It is class legislation. It arbitrarily and unnecessarily interferes with the accounting systems of every corporation to which it applies. . . . We are not living in an era of arbitrary personal government that will permit legislative authority to order sweeping changes in business methods regardless of

the wishes of the people. We believe we still have a representative government and that it is the duty of our representatives properly to express the will of the people in the laws they enact. This law has been enacted without authority from the people, expressed in petition or in the declaration of any political platform."

Lawson Purdy, President of the Department of Taxes and Assessment of New York City, is quoted as saying:

"From whatever point of view the Federal Corporation Tax is studied it is unworkable and unjust; it encroaches upon the powers of the states; it is not productive of revenue; it is needlessly inquisitorial; the publicity required is rash and dangerous in the extreme. Its name is a subterfuge. It is an income tax and not an excise tax. It has the vices of income taxes without the merits of an income tax scientifically framed."

As to its supervisory features, President Taft in his speech at Denver, is quoted in the *New York Independent* as saying:

"Incidentally it will give the federal government an opportunity to secure most valuable information in respect to the conduct of corporations, their actual financial condition, which they are required to show in general terms in a public return. In addition the law provides the means under proper limitations of investigating fully and in detail their courses of business."

In the *Salem (Oregon) Statesman* he is quoted as saying: "It is a tax upon success and not failure" and that paper goes on to remark that the doctrine is based upon the common sense theory of an equitable distribution of taxation upon those who are abundantly able to bear a share of the burden.

A Nebraska Senator in a speech reported by the *Omaha Bee*, praises the publicity feature of the law because it will enable minority stockholders to know just what those in control of a corporation are doing, and remarks that a still greater value to the public is that the criminal manipulator of stocks is put out of business by the law. The *Denver Republican* rejoices that many fake irrigation schemes and wildcat mining companies will be forced to go out of business because the report makes it necessary to state their incomes and disclose the extent of their possessions.

The *Jersey City Journal* believes that federal supervision that will prevent enforced competition and stock watering would be wise and possible without the inquisitorial system of the new law. The *New York Tribune*, speaking editorially, says, it has always favored a larger degree of publicity in the management of corporations in which public interests are deeply involved. It believes the tendency to enforce such publicity is also powerful in general and has produced important results. It refers to the fact that railroad corporations are now under the supervision and control of federal commissions, while insurance companies and trust companies are under close governmental scrutiny. It asks if the burdens and inconveniences of the proposed supervision for purpose of federal taxation will not fall chiefly on the lesser corpo-

rations which need no special control or regulation; as to most of the great corporations supervision would be merely duplicated, while for the smaller corporations it would be burdensome and practically barren.

Many business men are under the impression that the returns to be made under the law will be kept from the public, but Section 6 of the law reads as follows:

"When the assessment shall be made, as provided in this section, the returns, *together with any corrections thereof* which may have been made by the commissioner, shall be filed in the office of the Commissioner of Internal Revenue and *shall constitute public records and be open to inspection as such.*"

The information obtained by the investigations which the law authorizes government officials to make into the businesses of corporations can be divulged only by special direction of the President. On this point President Taft, according to the *New York Independent*, is quoted as saying:

"Indirectly it (the law) would help very much in another tariff revision, whenever that shall come, because corporations engaged in businesses said to be affected by the tariff will have upon record in Washington their exact financial condition from year to year in the matter of their incomes, their expenditures and their debts."

Occasions will not be slow to arise when the divulging of special information obtained under the law will be necessary. No law could present a finer opportunity for the collection of evidence to be used in government suits against corporations.

As to its tax features, the specific objections to the working out of the law which have appeared up to this time are as follows:

(1) That it provides for the making of reports covering the calendar year.

It is contended that in very few corporations does the fiscal year correspond with the calendar year, and to make correct reports covering a period other than the fiscal year will be extremely difficult, if not impossible. The American Association of Public Accountants suggests that the law be so amended as to permit the return to be based upon the last completed fiscal year prior to December 31st. This objection of the Association to the calendar year seems to have been made under the misapprehension that the law required a return of the net "profits." The Attorney-General thereupon calls attention to the fact that the law does not impose a tax upon "profits," but upon the net income, and believes that "it may be inconvenient, but it certainly is not impossible for any corporation which keeps just and true books of account to make a return such as is required by the proposed law."

(2) That the proper deductions are not made from the gross income.

The law provides that the "entire net income" is to be ascer-

tained by deducting from gross income expenses actually *paid*, losses actually *sustained* and interest actually *paid*. The association contends that the proper deductions should be: expenses actually *incurred*, losses actually *ascertained*, and interest actually *accrued*. To this the Attorney-General replies that the bill was purposely framed to deal with receipts and disbursements made within the year for which the tax is imposed, and the words "actually paid" were employed advisedly.

(3) That the system of accounting required in order to comply with the new law conflicts with other systems required by law.

The accountants also point out that the accounts of railroads are kept in a form prescribed by the Interstate Commerce Commission and severe penalties can be inflicted for any departure from those forms. They must be kept on a basis not of receipts and disbursements, but of earnings—whether collected in cash or not—and of expenses—whether paid or not—and that while it would be possible to prepare also an account of receipts and disbursements, this would involve a great deal of extra work in the compilation of special data and would raise most difficult questions as to proper distribution between capital and income of large payments for stores, the ultimate use of which is not and cannot be known at the time of payment. Referring to large manufacturing concerns, it believes that cash receipts arising from sales of product can be ascertained without much difficulty beyond requiring considerable extra work. But no system of accounting can give even approximately "the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties." A. L. Linn, Jr., General Auditor of New York State Railways, also calls attention to the fact that the Public Service Commission Law of the State of New York provides that the Commission for each district may prescribe the manner in which accounts shall be kept. He thinks the situation is still further complicated by the fixed provisions of the new law which necessitates a different classification of accounts and asks "why should a different classification be prescribed for purposes of taxation?"

The *Financial Age* believes that some corporations will split up into segments in order to fall within the \$5,000 exemption, while holding companies which are exempt will be created to recombine the various tax free units and so practically—though not technically—reconstitute the former status. This ingenious theory might not work out in practice, however, as incomes received from dividends on other corporations are exempt only when such corporations in turn are subject to the tax. The question would be whether a corporation whose net income is less than \$5,000 would be considered as subject to the tax.

It has frequently been suggested that as a method of avoiding the tax, corporations would dissolve and form co-partnerships. This suggestion was made before the convention of the National

Association of Agricultural Implement and Vehicle Manufacturers at Chicago. The Treasury Department, in a Washington dispatch, is reported as taking "little or no stock" in the statement that any corporation will adopt this plan.

The American Association of Public Accountants recommends measures looking toward an amendment of the law in the early days of the next congress and several authorities on taxation who denounce the law are in favor of fighting the measure at Washington by attempting to obtain a repeal. Business associations, however, seem to be unanimous in believing the best course is to fight it out in the courts.

Expressions of opinion as to the unconstitutionality of the law have been chiefly on the following points:

That although the new tax is called an excise tax in the hope of deceiving the Supreme Court when the law comes up for adjudication, it is in reality an income tax and as such is unconstitutional.

That it is in conflict with Paragraph 1 of Section 8 of Article 2 of the Constitution, that all duties, imposts, and excises shall be uniform throughout the United States.

The St. Louis *Republican* says:

"The proposed taxation by the federal government of franchises which it did not grant differs so little from direct taxation which the constitution forbids in the form proposed in this bill, that its fate would be little doubtful but for the presumption that the President knew in advance the opinions of the judges who will pass upon it in the Court of Last Resort."

The *Financial Age* believes the real salient points upon which the law seems likely to fall are that corporations are already by the corporation laws under which they exist fully licensed to do all lawful business except in wares expressly subject to excise—such as intoxicating liquors; that corporations being vested with all the powers and privileges of natural persons cannot lawfully be mulcted by means of any tax, excise or otherwise, to which natural persons would not be liable.

There is no doubt that opposition is forming against the tax. According to the *Denver Post*, Colorado corporations are intending to refuse the deputies of the Internal Revenue Office permission to examine their books as a preliminary step in fighting the law.

At the convention of the American Street Railway & Interurban Railroad Association held in Denver, October 4th, it was indicated that a vigorous assault would be made on the corporation tax. On the question of income tax there seemed to be a difference of opinion, but all of the delegates attending the convention appeared to be unanimous in denouncing the tax on corporations.

At a convention of some sixty life insurance companies doing business in the south and southwest, held on October 10th at

Cincinnati, a resolution was passed that prompt and proper steps should be taken to test the constitutionality of the act. It is also reported that former Senator J. B. Foraker will make a fight against the law in behalf of the Cincinnati Traction interests.

At a convention of Agricultural Implement and Vehicle Manufacturers held in Chicago, the attorneys for the association submitted a report, the conclusion of which was summed up in the following language:

"While we are not yet prepared to say that the law is unconstitutional, still our inclination is that there is sufficient doubt as to the constitutionality of the law to make it advisable that every step taken by the members of the association toward compliance with the law should be taken under protest.

"There should be no voluntary reports, no voluntary statements, no voluntary payments, but each report or statement should be made under protest."

Meanwhile preparations are going on to enforce the law. Internal Revenue Commissioner Cabell has been in frequent conference with the Secretary of the Treasury. Regulations are being drafted and the Department of Internal Revenue hopes to be in a position to make definite rulings on specific points within the next fifteen or thirty days. The various revenue collectors all over the country are sending out letters to corporations within their districts requesting such corporations to furnish them with information as to

- (1) Name of the corporation.
- (2) Nature of business.
- (3) Principal place of business.
- (4) Amount of capital stock.
- (5) In what state organized.

The answer given to question Number 3 will probably determine where the return is to be sent and from where the corporation is to be taxed.

It is estimated that over eighty thousand corporations have been organized in the State of New York; fifty thousand have been organized in New Jersey since 1848, and a majority of those now in existence are scattered all over the country; fifteen thousand corporations—domestic and foreign—are recorded upon the books of the Secretary of State of Ohio; the records of the Secretary of State of Illinois show that fourteen thousand domestic corporations and fifteen hundred foreign corporations are registered in that state. The total number of corporations to which a form of return will have to be sent by January 1st can only be guessed at at the present time. The Internal Revenue Department does not count on any unusual difficulty in collecting the tax, but it is believed, however, that an attempt will be made to amend the law so as to require corporations to register with collectors by January 1st, in order that the collectors may know to whom to send the blanks and from whom to expect returns.

THE TAXATION OF CORPORATIONS was the principal subject considered at the third Tax Conference under the auspices of the International Tax Association held at Louisville, Ky., September 21st to 24th. This Association has for its purpose the discussion of principles, theories and policies for the improvement of state and local taxation laws, particularly with a view to simplifying administrative methods. Delegates appointed by the governors of forty states, and from several of the provinces of Canada, as well as professors of economic and political science, attended the conference. At this conference the subject of uniform classification of real property was discussed and the recent compilation by the United States Bureau of Corporations of state laws relating to corporate taxation was commended. A committee of three members was authorized to co-operate with a similar committee appointed by the American Bar Association to draft a model inheritance tax law which will prevent the taxation of the same property by two or more states. Another committee was authorized to investigate the failure of the General Property Tax and to report to the next annual conference on the advisability of substituting an income tax, in whole or in part, for the personal property tax. The question of uniform taxation of the business of insurance was also taken up. The conference did not assume a definite stand on the subject of the Federal Corporation Tax Law, but requested its Chairman, the Governor of Kentucky, to submit the subject for consideration at the conference of the Governors to be called this winter.

NEW LEGISLATION IN 1910. The legislatures of thirteen states will meet in regular session. Three states are scheduled to meet in extraordinary session and it is probable that a large number of the other states may meet in order to vote on the proposed amendment to the federal constitution providing for an income tax. Other matters may receive attention, as the constitutions of most of the states provide that at extraordinary sessions, subjects other than those outlined in the Governor's call may be considered. To follow the progress of legislation is no easy task. Amendments, changes in committee and substitutions require constant watching in order to keep track of measures being enacted into law. It is not uncommon for the legislatures in the last days of the session to substitute important general measures for unimportant local ones before them and to enact into law measures that actually have not passed through the customary steps of first, second and third reading. The present anti-trust law of Iowa is an example of this, as well as several laws in Delaware.

Preparations are now being commenced in our Legislative Department to collect and classify the legislation of 1910, and to distribute the information to our clients. Many large corporations realize the importance of a systematic and constant attention to new legislation and are closing contracts with us for the coming year. A representative of the Company will be pleased to call in any of the large cities and explain in detail our system of collecting and distributing information and its convenience to clients.

FEDERAL CORPORATION TAX

Following our usual practice, we will have on file in our various offices, for the convenience of Members of the Bar, information relative to the interpretation of

THE FEDERAL CORPORATION TAX LAW.

We will be prepared to assist in the preparation and filing of the

FEDERAL CORPORATION TAX RETURNS

and endeavor to have on hand extra copies of the blank forms for making such returns.

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